[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS
(S. 499, S. 831, S. 842, S. 1231, S. 1807, AND S. 1914)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON OCTOBER 28, 1983

PREPARED BY THE STAFF

OF THE

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CONTENTS

	Page
INTRODUCTION	1
I. SUMMARY	3
II. DESCRIPTION OF THE BILLS	6
1. S. 499 (Senators D'Amato, Roth, and others): Requirement that certain Small Business Administration guarantees be available in connection with tax-exempt bonds	6
2. S. 831 (Senator Specter): Tax treatment of sale of principal residences with retention of life estate and S. 1914 (Senator Specter): Tax treatment of sale-leasebacks of principal residences	11
a. S. 1914	15
b. S. 831	16
3. S. 842 (Senators Weicker, Heinz, Boren, Baucus, Durenberger and others): Tax treatment of small business participating debentures	18
4. S. 1231 (Senators Boren, Matsunaga, Mitchell, Symms, Baucus, Pryor, and Wallop): Exemption from excise tax on heavy trucks and trailers for certain piggyback trailers and semitrailers	21
5. S. 1807 (Senators Percy and Dixon): Exclusion of certain foreign agricultural commodity income as foreign personal holding company income	23

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on October 28, 1983, by the Senate Finance Subcommittee on Taxation and Debt Management.

There are six bills scheduled for the hearing. Two of the bills (S. 831 and 1914) relate to the tax treatment of sales of interests in principal residences. S. 499 would provide that Federal guarantees provided by the Small Business Administration under its guaranteed debenture and pollution control programs could be used in conjunction with tax-exempt financing. S. 842 would provide special tax rules for small business participating debentures. S. 1231 would exempt certain piggyback trailers and semitrailers from the excise tax on heavy trucks and trailers. S. 1807 would exclude dividends attributable to certain foreign agricultural commodity income from taxation under the anti-tax haven provisions.

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, issues, explanation of provisions, and effective dates.

I. SUMMARY

1. S. 499 — Senators D'Amato, Roth, and Others

Requirement That Certain Small Business Administration Guarantees Be Available in Connection With Tax-exempt Bonds

Under present law, the Small Business Administration (SBA) is authorized to guarantee debentures issued by State and local development companies to finance up to 50 percent of qualified small business projects. The SBA is further authorized to guarantee payments made by eligible small businesses in connection with governmentally mandated pollution control devices.

The statutes authorizing the guaranteed debenture and pollution control guarantee programs allow the guarantees to be made in connection with tax-exempt financing (thereby providing an effective guarantee for the tax-exempt bonds). However, the current practice of the SBA is to avoid participation in projects involving tax-exempt financing.

The bill would prohibit the SBA from declining to participate in projects, under the guaranteed debenture and pollution control programs, because of the presence of tax-exempt financing. The bill would further provide that it is the declared policy of Congress that the guarantee of payments for a pollution control facility would not cause the interest on tax-exempt bonds used to finance the facilities to become taxable.

2. S. 831 — Senator Specter

Tax Treatment of Sale of Principal Residences With Retention of Life Estate

and

S. 1914 — Senator Specter

Tax Treatment of Sale-leasebacks of Principal Residences

Under present law, whether a homeowner has engaged in a sale-leaseback of his principal residence which will be respected for tax purposes is largely a question of fact. If the transaction is so respected, the seller will be treated as having sold his principal residence, and the purchaser may be entitled to depreciate the property. S. 1914 would provide safe harbor rules for determining whether a valid sale-leaseback of a principal residence has occurred. It also would clarify the treatment of such a transaction under various provisions of the Code.

Also under present law, the purchaser of a remainder interest in property is not entitled to take depreciation deductions with re-

spect to the property. S. 831 would allow the purchaser of a remainder interest following a life estate in a principal residence to depreciate the property. It also would allow the sale of such a remainder interest in a principal residence to qualify for the $125,000 exclusion described in Code section 121 (if the other requirements of that section are met).

3. S. 842—Senators Weicker, Heinz, Boren, Baucus, Durenberger, and Others

Tax Treatment of Small Business Participating Debentures

The bill would provide tax incentives for the creation of, and investment in, a new type of security, the Small Business Participating Debenture (SBPD). A portion of the annual return on these debentures would be measured by reference to the earnings of the issuer. This portion would be treated as long-term capital gain by the investor and would be deductible as interest by the business. If an individual investor incurs a loss with respect to an SBPD, the loss would generally be treated as an ordinary loss (rather than a capital loss).

4. S. 1231—Senators Boren, Matsunaga, Mitchell, Symms, Baucus, Wallop, and Pryer

Exemption From Excise Tax on Heavy Trucks and Trailers for Certain Piggyback Trailers and Semitrailers

Present law (as amended by the Highway Revenue Act of 1982) imposes a 12-percent excise tax, effective April 1, 1983 through September 30, 1988, on the first retail sale of heavy trucks and trailers. Rail trailers designed for use both as a highway vehicle and as a railroad car are exempt from the tax. Piggyback trailers, which ride only on the highway but are equipped to be lifted onto flatcars in order to travel by rail, are not exempt from the excise tax.

The bill would exempt piggyback trailers and semitrailers from the tax on heavy trucks, trucks and trailers. The exemption would be effective as if included in the Highway Revenue Act of 1982.

5. S. 1807—Senators Percy and Dixon

Exclusion of Certain Foreign Agricultural Commodity Income as Foreign Personal Holding Company Income

Under present law, dividends received by a foreign corporation which is controlled by U.S. shareholders are considered foreign personal holding company income and as such may be taxable to the U.S. shareholders. The fact that the underlying income of the payor corporation is not taxable to the U.S. shareholders does not relieve the dividend from being foreign personal holding company income.

Under the bill, dividends received by a controlled foreign corporation will not be considered foreign personal holding company income for purposes of the anti-tax haven provisions (Code secs. 951–64, often referred to as subpart F) if the following conditions are met: (1) the dividends are paid out of earnings and profits of

another foreign corporation for a taxable year in which at least 70 percent of the payor corporation's gross income (other than subpart F income) is from the purchase or sale of agricultural commodities not grown in the United States in commercially marketable quantities, (2) the corporations are members of the same affiliated group and a U.S. shareholder owns more than 50 percent of the stock of both, and (3) certain five-year active business and length of existence requirements are met.

II. DESCRIPTION OF THE BILLS

1. S. 499 — Senators D'Amato, Roth, and others

Requirement That Certain Small Business Administration Guarantees Be Available in Connection With Tax-exempt Bonds

Present Law

Federal income tax rules

Tax exemption for State and local obligations

Interest on State and local government obligations generally is exempt from Federal income tax. Under this rule, State and local governments generally may issue tax-exempt bonds to finance public projects or services, including schools, roads, water, sewer, and general improvement projects and the financing of public debt. Additionally, State and local governments may provide tax-exempt financing for student loans and for use by tax-exempt religious, charitable, scientific, or educational organizations.

Industrial development bonds

Under present law, industrial development bonds (IDBs) are taxable except when issued for certain specified purposes. Industrial development bonds are obligations issued as part of an issue all or a major portion of the proceeds of which are to be used in any trade or business carried on by a non-exempt person and the payment of principal or interest on which is derived from, or secured by, money or property used in a trade or business.

One of the exceptions under which interest on IDBs is tax-exempt is where the proceeds of the IDBs are used for specific exempt functions. These include IDBs the proceeds of which are used to provide air or water pollution control facilities (sec. 103(b)(4)(F)). Interest on IDBs is also tax-exempt if the bond proceeds are used to finance (1) projects for low-income multifamily rental housing, (2) sports facilities, (3) convention or trade show facilities, (4) airports, docks, wharves, mass community facilities, or parking facilities, (5) sewage and solid waste disposal facilities, (6) facilities for the local furnishing of electricity or gas, (7) certain facilities for the furnishing of water, (8) qualified hydroelectric generating facilities, (9) qualified mass commuting vehicles, (10) local district heating or cooling facilities, or (11) land acquired or developed as the site for an industrial park.

Present law also provides a tax exemption for interest on certain "small issue" IDBs the proceeds of which are used for the acquisition, construction, or improvement of certain land or depreciable property. The exemption applies to issues of $1 million or less without regard to related capital expenditures. Alternatively, the

amount of the issue, together with certain related capital expenditures over a 6-year period, must not exceed $10,000,000.

Treasury regulations provide that pollution control devices eligible for tax-exempt financing include property to be used, in whole or in part, to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, or storing pollutants, contaminants, wastes, or heat. Treas. Reg. sec. 1.103-8(g)(2)(ii).

Small Business Investment Act

SBA-guaranteed debentures

Under the Small Business Development Center Act of 1980 (P.L. 96-302),[1] the Small Business Administration (SBA) is authorized to guarantee debentures issued by State or local certified development companies (CDCs) to finance the purchase of land, plant and equipment (i.e. fixed assets) for qualifying small business concerns. The debentures are to be used to make loans for up to 50 percent of the costs of a project, to a maximum of $500,000. The program is designed so that the SBA-guaranteed loan may be leveraged in order to encourage the private sector to make long-term capital available to the project.

The statute enacting the guaranteed debentures program provides that debentures guaranteed under the program may be subordinated to any other debenture, promissory note, or other debt or obligation issued by the State or local development company. The statute further provides that the full faith and credit of the United States is pledged to the payment of amounts guaranteed under the program.

SBA regulations provide that loans made with the proceeds of SBA-guaranteed debentures may be subordinated to repayment of tax-exempt obligations used to finance the same projects (thereby providing an indirect guarantee for the tax-exempt obligations).[2] However, proposed SBA regulations provide that the SBA will not participate in projects in which loans made with the proceeds of guaranteed debentures are subordinated to loans made with the proceeds of tax-exempt bonds.[3] This policy has been explained by the Administration as part of a general policy of discouraging Federally-guaranteed tax-exempt obligations.[4]

Pollution control guarantees

Under 1976 amendments to the Small Business Investment,[5] the SBA is authorized to guarantee 100 percent of the payments due from eligible small businesses under contracts for the planning, design, or installation of governmentally mandated pollution control facilities. The statute enacting this program provides specifically that, notwithstanding any contrary law, rule or regulation or fiscal policy, the guarantee authorized in the case of pollution control facilities or property may be issued when such property is ac-

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[1] Sec. 503 of the Small Business Investment Act of 1958 (15 U.S.C. sec. 697)

[2] 13 C.F.R. sec. 108.503-4(c).

[3] Proposed Regs., 13 C.F.R. sec. 108.503-4(c), Fed. Reg., March 7, 1983.

[4] See Committee on Small Business, Subcommittee on Urban and Rural Economic Development, Hearings on SBA's Economic Development Programs, testimony of Roger Mehle (Deputy Assistant Secretary of the Treasury), September 28, 1982.

[5] Sec. 404 of the Small Business Investment Act of 1958 (15 U.S.C. sec. 694-1).

quired with the proceeds of tax-exempt industrial revenue bonds. The statute provides that any further such guarantee shall be a full faith and credit obligation of the United States.

The SBA announced in January, 1982, that it would not guarantee further pollution control projects financed with tax-exempt obligations. At the time of this amendment, all or virtually all SBA-guaranteed pollution control projects had been financed with tax-exempt obligations.

The Internal Revenue Service, in 1978, stated that the interest on pollution control IDBs issued for SBA-guaranteed projects is exempt from tax. Rev. Rul. 78-171, 1978-1 C.B. 29.

Precedents for Federal guarantees of tax-exempt bonds

The Public Debt Act of 1941[6] prohibits the Federal Government from issuing tax-exempt obligations. Since that time, the Federal Government has generally refrained from guaranteeing tax-exempt State or municipal bonds. However, in certain limited cases, Federal agencies may provide additional security for tax-exempt bonds through (1) guarantee of obligations which are used to secure tax-exempt bonds or (2) subordination of debts owned to the Federal Government to the tax-exempt bonds. In other cases, the law specifically prohibits the guarantee of tax-exempt obligations.

New York City loan guarantees—The New York City Financial Assistance Act of 1978 (Pub. L. 95-339) authorized the Treasury Department to guarantee payment of interest and principal on New York City indebtedness issued to certain public employee pension funds. The Act provided specifically that any guaranteed obligation would be treated as a taxable obligation with respect to interest accrued during the guarantee period. The Conference Report accompanying the Act[7] states that the conferees sought to avoid establishing a precedent for tax-exempt federally guaranteed obligations since obligations which combined a Federal guarantee and tax-exempt interest would be more desirable to investors than United States Treatury obligations (which are taxable) or other obligations issued by State or local governments (which are tax-exempt but not federally guaranteed).

Department of Agriculture (Farmers Home Administration)—The Farmers Home Administration (FmHA) guarantees loans for various agricultural purposes. The FmHA amended its regulations in 1982 to provide that the FmHA will not guarantee loans made with the proceeds of tax-exempt obligations.[8] Additionally, no FmHA loan may serve as collateral for a tax-exempt issue.

Housing and Urban Development—Section 11(b) of the Housing Act of 1937 provides a special tax exemption for obligations issued by State and local housing agencies in connection with low-income housing projects. The Act[9] prohibits the Department of Housing and Urban Development (HUD) from guaranteeing any tax-exempt obligation issued by a State or local agency. However, under certain circumstances, an issuer may pledge HUD loans or contribu-

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[6] 55 Stat. 7 (1941).
[7] H. Rep. No. 95-1369, accompanying H.R. 12426, 95th Cong., 2d Sess. (July 18, 1978).
[8] 7 C.F.R. sec. 1980.23.
[9] 42 U.S.C. sec. 1437c(g).

tions (which are backed by the full faith and credit of the United States) as security for tax-exempt obligations.

Mortgage insurance—The Department of Housing and Urban Development, Federal Housing Authority is authorized to insure mortgages on various properties, including certain owner-occupied housing, rental and cooperative housing, housing for moderate income and displaced families, housing for elderly persons, and hospitals and nursing homes.[10] These may include mortgages on properties constructed with tax-exempt financing. In these situations, FHA-insured mortgages may be pledged as security for tax-exempt bonds. Under certain circumstances, mortgages insured by the Veterans Administration (VA) may also serve as security for tax-exempt bonds.

Student loan bonds—The Department of Education guarantees repayment of certain student loan bonds. In certain cases, these guaranteed loans may be pledged as security for repayment of tax-exempt bonds.

FSLIC-and FDIC-guaranteed bonds—The Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Deposit Insurance Corporation (FDIC) insure deposits to a maximum of $100,000 per depositor.[11] In certain issues of tax-exempt bonds, the issuing authority has deposited the bond proceeds in bank or savings and loan accounts insured by the FSLIC or FDIC, to be loaned to the user by the depository institution (loans-to-lenders programs). Because in the typical arrangement a trustee for the bondholders holds a certificate of deposit in an FDIC or FSLIC insured institution, the repayment of the bonds is effectively guaranteed to the extent of $100,000 per depositor.[12]

Energy program guarantees—Under certain energy production or conservation programs, the Federal Government may guarantee the payment of principal or interest on IDBs used to finance qualified hydroelectric generating facilities or qualified steam-generating or alcohol-producing facilities. The Internal Revenue Code (sec. 103(h)) eliminates the tax exemption for bonds guaranteed under these programs. Additionally, the tax exemption is eliminated when principal or interest on the bonds is to be paid with funds provided by Federal, State or local governments under an energy production or conservation program.

Issues

The principal issue is whether projects financed with tax-exempt bonds should be entitled to receive effective Federal guarantees under the SBA-guaranteed debenture and pollution control programs. Related issues include:

First, do Federal guarantees for tax-exempt bonds have a detrimental effect on the market for Federal securities?

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[10] National Housing Act of 1934, 12 U.S.C. sec. 1707 et. seq.

[11] See 12 U.S.C. sec. 1724(b) and 12 C.F.R. secs. 564.2(c) and 564.8 (FSLIC); 12 U.S.C. sec. 1817(i) and 12 C.F.R. secs. 331(b) and 330.8(b) (FDIC).

[12] S. 1061, introduced by Senators Dole and Symms, would eliminate the tax exemption for any obligation which was part of an issue a significant portion of the principal or interest on which is to be insured (directly or indirectly) by a Federal deposit insurance agency as a result of the investment of the proceeds in deposits or accounts of a federally insured financial institution. The bill would generally be effective for obligations issued after April 15, 1983.

Second, do such guarantees increase the volume of tax-exempt bonds and, therefore, have a detrimental effect on State and local borrowing for traditional public purposes?

Third, how can guarantees of small business projects be distinguished from other Federal guarantees?

Explanation of the Bill

SBA-guaranteed debentures

The bill would amend the Small Business Investment Act to prohibit the Administration from declining to guarantee debentures for a project because the other sources of financing for the project include or are collateralized by tax-exempt bonds (Code sec. 103(b)). Additionally, the bill would provide that no Federal agency or official (including the Administration) may restrict the use of guaranteed debentures in connection with tax-exempt obligations if the project otherwise complies with the requirements of the program. The bill would further provide that, where the financing for a project includes or is collateralized by tax-exempt obligations, SBA-guaranteed debentures (or loans made with the proceeds of these debentures) shall be subordinated to the tax-exempt obligations.

Pollution control guarantees

The bill would amend the Small Business Investment Act to provide that, notwithstanding any contrary law, rule, or regulation or fiscal policy and subject only to the existence of qualified guarantee applications and available statutory authority, the Administrartion may not decline to issue guarantees of pollution control facilities or property. Thus, under the bill, the Administration would be prohibited from denying a guarantee application because of the presence of tax-exempt financing. The bill would further provide that it is the declared policy of Congress that the guarantee of payments for pollution control facilities would not cause the interest on tax-exempt obligations used to finance the facilities to become taxable.

Prior Congressional Action

The bill (S. 499) has been reported favorably by the Committee on Small Business and was subsequently referred to the Committee on Finance. S. Rep. 98-22, 98th Cong., 1st Sess. (March 11, 1983).[13]

Effective Date

The bill would be effective upon the date of enactment.

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[13] The House Committee on Small Business has reported a similar measure, in H.R. 3020. H. Rep. No. 98–182, 98th Cong., 1st Sess. (May 16, 1983).

2. S. 831 — Senator Specter

Tax Treatment of Principal Residences With Retention of Life Estate

and

S. 1914 — Senator Specter

Tax Treatment of Sale-leasebacks of Principal Residences

(Home Equity Conversion Act of 1983)

Present Law

In general

A sale-leaseback is any transaction in which the owner of property sells the property and then leases the property back from the purchaser. In general, if a valid sale-leaseback with respect to property occurs, the purchaser-lessor is entitled to depreciate its basis in the property, and the seller-lessee, if it uses the property in a trade or business or holds the property for the production of income, can deduct rental payments. The purchaser-lessor generally can also deduct any property taxes and any interest paid or accrued on any indebtedness incurred to purchase the property.

Under present law, a homeowner may make a sale-leaseback of his principal residence which will be respected for tax purposes. In a valid sale-leaseback, the sale and the leaseback are generally treated as separate transactions. Thus, in the case of a valid sale leaseback of a principal residence, the seller may elect to exclude from gross income up to $125,000 in gain on the sale under the provisions of section 121 if the requirements of that provision are met. Furthermore, the purchaser-lessor of the property would be entitled to depreciate the property and to deduct such expenses in connection with the ownership or operation of the property as may be allowable as ordinary and necessary business expenses (or expenses paid or incurred for the production of income). However, if the sale-leaseback transaction were not entered into by the purchaser-lessor for profit, depreciation deductions and deductions for such expenses would be limited.

Whether a sale-leaseback transaction will be respected for tax purposes is largely a question of fact. Some of the relevant factors include whether (1) the sale price equals the property's fair market value, (2) a reasonable rate of interest is charged on any purchase money indebtedness, (3) the rent equals fair rental value for the property for the term of the lease and any renewals, (4) the benefits and burdens of ownership fall on the purchaser-lessor (and not on the seller-lessee as, for example, with a repurchase option at a

fixed price), (5) the parties intend a sale-leaseback (as opposed to a mere purchase option, financing device or tax avoidance scheme), and (6) the transaction is structured as a sale-leaseback (as opposed to a sale of a remainder interest only or some other transaction).

A sale at less than fair market value, or a lease at less than fair rental value, will not necessarily invalidate a sale-leaseback transaction for tax purposes. However, such a discounted purchase price or discounted rentals may be treated as a payment to the benefited party.[1] Thus, if a homeowner engages in a sale-leaseback with respect to his principal residence and discounts the sale price in return for a lower than fair rental value rent, the homeowner could be deemed to have received a fair market value sale price and to have prepaid the difference between the discounted value of a fair rent on the property and the discounted value of the actual rent to be paid on the property.

Sale of a remainder

A transaction with an economic result similar to that of a sale-leaseback is a sale by a property owner of a remainder interest in the property. In such a transaction, the seller may retain a life estate in the property (or an estate for a term of years). In the case of a life estate, the owner of the remainder interest has the right to possess the property on the termination of the measuring life or lives. In general, in the case of a lease, the lessor has the right to possess the property at the end of the lease term.

In the case of the purchase of a remainder interest, the purchaser is not entitled to depreciate the property. Rather, the entire depreciable interest is deemed to remain with the holder of the life estate (section 167(h)). In addition, it has been held that the remainder interest itself cannot be depreciated until the prior estate terminates. *Geneva Drive-In Theater, Inc. v. Commissioner,* 67 T.C. 764 (1977), *aff'd per curiam,* 622 F. 2d 995 (9th Cir. 1980). However, in general, interest paid or incurred by the purchaser of a remainder interest with respect to any acquisition indebtedness would be deductible, subject to other limitations of the Code which may apply. Because the seller of the remainder interest following a life estate retains the right of possession during his lifetime, generally no rental payments would be paid to the holder of the remainder interest.

Exclusion from gross income of sale proceeds on sale of principal residence by elderly seller

Under present law, a taxpayer may elect to exclude from gross income up to $125,000 [2] of any gain realized on the sale or exchange of his principal residence (section 121). That election is available to the taxpayer only if the taxpayer has attained the age of 55 before the date of the sale or exchange and only if the property sold was owned and used by the taxpayer as his principal residence for periods aggregating at least three years during a five year period ending on the date of the sale or exchange. In general,

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[1] See and compare, *Alstores Realty Corp. v. Commissoner,* 46 T.C. 363 (1966), acq. 1967-2 C.B. 1, and *Giberson v. Commissioner,* 44 T.C.M. 154 (1982), with Rev. Rul. 77-413, 1977-2 C.B. 298.

[2] $62,500 in the case of a married individual filing a separate return.

the election is available only once to a taxpayer.[3] In the case of stock in a cooperative housing corporation, the holding and use requirements apply to the taxpayer's stock ownership in the corporation and right to possess a particular apartment in the building.

The sale by a taxpayer of his principal residence in a valid sale-leaseback transaction will generally qualify for treatment under section 121. However, the sale of the remainder interest in a principal residence may not.

Depreciation

Property which is recovery property may be depreciated under one of the accelerated cost recovery (ACRS) schedules contained in section 168. In general, recovery property is tangible depreciable property, whether new or used. Each item of recovery property under ACRS falls into one of five classes.[4] Depreciable property is any property used in a trade or business or held for the production of income which has a determinable limited useful life. Under ACRS, real property can be depreciated over a 15-year period by applying recovery percentages that approximate use of the 175-percent declining balance method in early years and the straight-line method in later years.

Anti-churning rules exclude property acquired after 1980 from the definition of recovery property if such property was owned by the taxpayer or a related person in 1980. Similarly, depreciable real property leased after 1980 to a person who owned the property in 1980 or a related person is not recovery property. The anti-churning rule would apply, for example, if an investor-lessor entered into a sale-leaseback in 1980.

Depreciable property that is not recovery property may be depreciated over its useful life (sec. 167). In most cases, the useful life of used real property exceeds 15 years (the recovery period under ACRS). Under section 167, the most accelerated depreciation method allowed for used residential rental property is the 125-percent declining balance method.

Activities not engaged in for profit

In general, unlimited deductions (other than for interest and taxes) are allowable only with respect to an activity which is engaged in for profit. If an individual or an S corporation engages in an activity not for profit, then no deductions (other than for interest and taxes) attributable to such activity are allowable in excess of a certain amount (sec. 183). That amount is the gross income attributable to such activity minus interest and taxes attributable to such activity. An activity is presumed to be engaged in for profit if gross income from such activity exceeds the deductions attributable to such activity during any two or more years during a five consecutive taxable year period ending with the current taxable year. The Tax Court has held that the purchase and leaseback of a principal residence in a sale-leaseback can be a transaction entered

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[3] Elections with respect to sales or exchanges on or before July 26, 1978, are ignored.

[4] These classes are 3-year property, 5-year property, 10-year property, 15-year real property, and 15-year public utility property.

into for profit by the purchaser. *Langford* v. *Commissioner,* 42 T.C.M. 1160 (1981).

Installment sales

In general, the sale by a taxpayer of his principal residence may be reported as an installment sale. Subject to certain exceptions, a sale is an installment sale if at least one payment is to be received after the close of the taxable year in which the sale (or other the disposition) occurs. If a sale is an installment sale, the gain on the sale which is recognized in any taxable year is that proportion of the payments received in that taxable year which the gross profit on the sale (or other disposition) bears to the total contract price. Thus, under the installment sales method, gain on a sale or other disposition is recognized as payments on the sales price are received. However, while income recognition to the seller is deferred, the purchaser in such a transaction is generally entitled to commence depreciating the property immediately.

In general, the term "payment" under the installment sales provisions does not include receipt of an evidence of indebtedness of the purchaser, even if such obligation is guaranteed by a third party. However, payment generally does include receipt of an evidence of indebtedness of a person other than the purchaser. The installment sale rules can also apply to contingent payment sales. A contingent payment sale is any sale or other disposition of property in which the aggregate selling price cannot be determined at the close of the taxable year in which the sale or other disposition occurs. Under present law, if all or a portion of the purchase price consists of an annuity, it is possible (depending upon the terms of the individual annuity) that the annuity could be viewed as a payment to the extent of its fair market value in the year of receipt. If the purchaser is the issuer of the annuity, the transaction could be viewed as a sale for a contingent payment sale.

Business use of principal residence

In general, trade or business expenses are not allowable with respect to the business use by a taxpayer of his principal residence. Certain exceptions to this general rule apply, however. As one exception, if a portion of a principal residence is used exclusively as the principal place of business for any trade or business of the taxpayer on a regular basis, expenses allocable to that portion of the dwelling unit are allowable to the extent of the excess of the gross income derived from such use by the taxpayer for the taxable year over deductions allocable to such use which would otherwise be allowable under the Code. Another exception applies with respect to a taxpayer who rents a dwelling unit at a fair rental to any person for use as such person's principal residence pursuant to a shared equity financing agreement. For this purpose, a shared equity financing agreement means any agreement under which two or more persons acquire an undivided interest for more than 50 years in the entire dwelling unit and one of those persons is entitled to occupy the dwelling unit for use as a principal residence subject to an obligation to pay rent to one or more other persons holding an interest in the dwelling unit.

Explanation of the Bill

a. *S. 1914: Tax treatment of sale-leasebacks of principal residences*

In general

Under the bill, a safe harbor for homeowner sale-leasebacks would be established. A variety of tax benefits would accrue to the parties to a qualified sale-leaseback transaction. A qualified sale-leaseback transaction is a sale-leaseback which meets certain requirements. The seller-lessee must have attained the age of 55 before the date of the transaction. In addition, the seller-lessee must sell property which was owned and used by the seller-lessee as his principal residence at the time of the transaction and which had never been depreciable real property in his hands. The seller-lessee must retain occupancy rights in such property pursuant to a written lease requiring the payment of a fair rent. Finally, the purchaser-lessor must be a person contractually responsible for the risks and burdens of ownership [5] after the date of the transaction.

For this purpose, the term "occupancy rights" means the right to occupy the property for a term which equals or exceeds one-half the life expectancy of the seller-lessee (or the joint life expectancies of the seller-lessees in the case of jointly-held occupancy rights) at the date of the transaction. The right must be continually renewable by the seller-lessee (or the surviving spouse in the case of jointly held occupancy rights) and must terminate no later than the death of the seller-lessee (or the surviving spouse in the case of jointly-held occupancy rights). For this purpose a fair rental is any rent which is determined on the date of the sale-leaseback transaction and which equals or exceeds 80 percent of the appraised fair market rent for the term of the occupancy rights.

The bill's sale-leaseback safe harbor is not intended to create any inference as to the correct treatment of any transactions falling outside such safe harbor.

Depreciation

Under the bill, the purchaser-lessor in any qualified sale-leaseback transaction would be allowed any depreciation on the property as if he were the sole owner of the property.[6]

Exclusion from gross income and amount realized

For purposes of section 121, a sale or exchange would include the sale of a principal residence in a qualified sale-leaseback transaction. Thus, in such a case, the seller could elect to exclude from gross income $125,000 of gain from the sale or exchange.

In addition, new section 121A would be added to the Code. This provision would exclude from gross income of the seller the excess of the fair market value of any occupancy rights reserved or retained by the seller in a qualified sale-leaseback over the rent charged under the lease. Furthermore, none of such excess would be included under section 1001 as an amount realized on the sale.

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[5] While the bill refers to risks and burdens of ownership, it is intended that the purchaser-lessor must be entitled to the benefits of ownership as well.

[6] It is intended that the property involved in a qualified sale-leaseback transaction would be recovery property in all events.

In addition, new section 121A would exclude from the gross income of the purchaser any rent discount.

Application of installment sale provisions—receipt of annuity

The bill would provide a special rule for certain cases in which part or all of the consideration paid to the seller-lessee by the purchaser-lessor in a qualified sale-leaseback transaction is in the form of an annuity. In the case of an annuity purchased from a third party by the purchaser-lessor for the seller-lessee in a qualified sale-leaseback transaction, the cost to the purchaser of the annuity would be deemed to be the amount of the payment received by the seller. In addition, that amount would be deemed to be received by the seller in the year of the sale, even if payments on the annuity were deferred and contingent.

If the seller-lessee in connection with a qualified sale-leaseback transaction receives an annuity, the amount paid by the purchaser-lessor for the annuity would be treated as an investment by the seller-lessee in the annuity contract for purposes of section 72.

Transaction engaged in for profit

Any qualified sale-leaseback transaction would be presumed to be one engaged in for profit unless the Secretary of the Treasury establishes to the contrary. Thus, the purchaser-lessor would be allowed to deduct otherwise deductible expenditures without regard to the limitations applicable to transactions not entered into for profit.

Business use of principal residence rented under qualified sale-leaseback transaction

Under the bill, rent paid by a seller-lessee under lease constituting part of a qualified sale-leaseback transaction by the purchaser-lessor would not be subject to the business expense limitations imposed on persons making a business use of a residence.

Effective Date

The provisions of this bill would apply to sales after the date of enactment in taxable years ending after such date.

b. *S. 831: Tax treatment of sale of principal residences with retention of life estate*

Under the bill, Code section 121 would be amended to provide that the sale by a taxpayer of a remainder interest (following a life estate) in his principal residence would qualify for treatment under that provision.

In addition, any sale of a remainder interest qualifying under section 121 would also receive special treatment under the depreciation provisions of the Code. The purchaser of the remainder interest would be treated as the absolute owner of the property for depreciation purposes (including for accelerated cost recovery purposes).

Effective Date

The provisions of this bill would apply to sales or exchanges after the date of enactment in taxable years ending after such date.

3. S. 842—Senator Weicker, Heinz, Boren, Baucus, Durenberger, and Others

Tax Treatment of Small Business Participating Debentures

Present Law

Under present law, an investor who receives periodic distributions (i.e., interest) from a business with respect to a debt instrument is taxed at ordinary income rates on that income. Similarly, an investor who receives periodic distributions with respect to an investment in common or preferred stock (i.e., dividends) in the business is normally required to treat such income as ordinary income (to the extent that an exclusion or deduction for dividends received is not available).[1]

Further, in the case of an investor (other than a dealer), a loss on the worthlessness, sale, or other disposition of a debt instrument or share of preferred stock purchased for investment is ordinarily a capital loss. Similarly, a loss on the worthlessness, sale, or other disposition of a share of common stock is ordinarily a capital loss unless section 1244 applies. Under section 1244, an individual may treat losses on certain common stock issued by a small business as an ordinary loss (subject to certain limitations). This ordinary loss treatment under section 1244 is not available to an investor who invests in preferred stock or debt.

Under present law, a taxpayer may deduct interest paid or accrued on business indebtedness; however, a corporation is not entitled to deduct amounts paid as dividends on preferred or common stock.

Issues

The principal issue is whether tax incentives should be provided to encourage the issuance of, and the investment in, securities issued by small businesses which are characterized by participation in the current earnings of the business but not the underlying appreciation of the business. If so, a second issue is whether the types of incentives created by the bill are appropriate. A third issue is how a qualified small business should be defined.

Explanation of the Bill

In general

The bill would provide tax incentives for the creation of, and investment in, a new type of security, the Small Business Participat-

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[1] An individual is generally allowed an exclusion for up to $100 of dividends annually. Corporations are entitled to a dividends received deduction for 85 or 100 percent of the dividends received.

ing Debenture (SBPD). Under the bill, an SBPD could be issued only by a qualified small business and would be an instrument having characteristics of both debt and equity. A holder of an SBPD would treat interest payments received under the SBPD as ordinary income. Payments received as a share of the issuer's earnings would be treated as long-term capital gain. A loss incurred on the worthlessness, sale, or other disposition of an SBPD issued to an individual would generally be treated as if it were a loss on section 1244 stock. A small business issuing an SBPD would be permitted to treat all payments made under the SBPD as interest and, thus, would be allowed to deduct the amounts paid as shares of its earnings as interest (under sec. 163).

Definitions of SBPD and qualified small business

The bill defines an SBPD as a written debt instrument issued by a qualified small business which (1) is a general obligation of the business, (2) bears a stated rate of interest not less than the rate prescribed by the Secretary under section 483(c)(1)(B),[2] (3) has a fixed maturity, (4) grants no voting or conversion rights in the qualified small business to the purchaser, and (5) provides for the payment of a share of the total earnings of the issuer.

A qualified small business would be any domestic trade or business (whether or not incorporated) which (1) has equity capital not exceeding $10 million immediately before the SBPD is issued, and (2) has no securities outstanding which are subject to regulation by the Securities and Exchange Commission. Further, for a small business to be treated as a qualified small business, the face value of all the outstanding SBPDs issued by the business (including the SBPD being issued) must not exceed $1 million. For purposes of determining qualification as a qualified small business, the equity capital and outstanding SBPDs of all members of a controlled group would be taken into account. A controlled group would consist of all businesses under common control with the issuing corporation within the meaning of section 1563(a), except that a more-than-50-percent test would be applied rather than the 80-percent test. The same general principles would be applied to commonly controlled businesses which are not incorporated.

Tax treatment by the investor of income, gains, losses, etc., on the SBPD

Amounts received by a taxpayer (other than a taxpayer with a 10-percent equity interest in the business) as a share of the issuer's earnings on the SBPD would generally be treated as long-term capital gain. For the purpose of determining the tax treatment of any loss on the SBPD, the taxpayer would treat the loss as if it were on a loss on section 1244 stock. Thus, the taxpayer could be allowed an ordinary loss rather than a capital loss from the worthlessness or sale or exchange of the SBPD.

Tax treatment by the qualified small business of SBPD payments

Generally, both the amounts paid as interest and the amounts paid as a share of the issuer's earnings would be treated as interest

[2] That rate is presently nine percent.

and deductible under section 163 by the qualified small business which has issued the SBPD.

Effective Date

Generally, the provisions of the bill would apply to taxable years beginning after December 31, 1982, and to SBPDs acquired after the date of the enactment of the bill. However, the provisions of the bill would not apply to any SBPD issued before or during the calendar year 1983, if the proceeds of such SBPD are used to repay any loan of the issuing small business other than a loan with a stated rate of interest in excess of the prevailing rate of interest for businesses in the area where the business is located and which is secured by its inventory or accounts receivable.

4. S. 1231 — Senators Boren, Matsunaga, Mitchell, Symms, Baucus, Wallop, and Pryor

Exemption From Excise Tax on Heavy Trucks and Trailers for Certain Piggyback Trailers and Semitrailers

Present law

A 12-percent excise tax is imposed on the first retail sale of truck chassis and bodies, truck trailer and semitrailer chassis and bodies, and highway tractors used in combination with a trailer or semitrailer (including, in each case, related parts or accessories). Truck chassis and bodies are taxable only if suitable for use with a vehicle whose gross vehicle weight exceeds 33,000 pounds. Truck trailer and semitrailer chassis and bodies are taxable only if suitable for use with a trailer or semitrailer whose gross vehicle weight exceeds 26,000 pounds. A 12-percent retail tax also applies to the installation of nonreplacement parts and accessories on a taxable article, if installation occurs within 6 months after the article was placed in service and the aggregate value of installed parts (including installaton costs) exceeds $200 (Code sec. 4051).

Certain articles, including chassis and bodies (and related parts of accessories) of trailers and semitrailers designed for use both as a highway vehicle and as a railroad car (rail trailers), are exempt from the excise tax. In addition to their capacity to ride on the highways, the exempt rail trailers are equipped with train wheels which enable them to ride on rails. Piggyback trailers and semitrailers, which ride only on the highway, but are equipped to be lifted onto flatcars in order to travel by rail are not specifically exempt from the excise tax because they are not designed for use as a railroad car (Code sec. 4053).

The Highway Revenue Act of 1982 (the Act) converted the prior law 10-percent manufacturers excise tax on trucks and trailers into the 12-percent retail excise tax of present law, effective April 1, 1983. In addition, the Act provided the present exemption for rail trailers, effective January 7, 1983, and allowed refunds of the 10-percent tax to manufacturers for rail trailers purchased by the ultimate consumer after December 2, 1982.

The retail excise tax on trucks and trailers is scheduled to expire on October 1, 1988.

Issues

The primary issue is whether piggyback trailers are more properly treated as highway trailers, which are subject to the 12-percent retail excise tax, or as rail trailers, which are exempt from the tax. A second issue, relating to the yield and administration of the tax, is whether the additional cost of equipping a trailer to be a piggyback trailer is large or small relative to the value of excise tax ex-

emption. A third issue is whether any exemption for piggyback trailers should be effective retrospectively (to the effective date of the present exemption for rail trailers) or prospectively.

Explanation of the Bill

The bill would exempt piggyback trailers and semitrailers (including parts or accessories) from the 12-percent retail excise tax on heavy trucks and trailers. A piggyback trailer or semitrailer would include any trailer or semitrailer which is designed for use principally in connection with trailer-on-flatcar rail service. The seller of the trailer or semitrailer would be required to certify that it would be used principally in connection with trailer-on-flatcar service, or incorporated into an article which will be used in this manner.

Effective Date

The bill would be effective as if included in that provision of the Highway Revenue Act of 1982 which exempted rail trailers. Thus, the exemption would apply to the 12-percent retail excise tax from its effective date of April 1, 1983, and to the previous 10-percent manufacturers excise tax from January 7, 1983, until its replacement by the retail tax on April 1, 1983. In addition, refunds of the 10-percent excise tax would be allowed to manufacturers of piggyback trailers sold to ultimate consumers after December 2, 1982.

5. S. 1807—Senators Percy and Dixon

Exclusion of Certain Foreign Agricultural Commodity Income as Foreign Personal Holding Company Income

Present Law

In the Revenue Act of 1962, Congress enacted legislation intended to tax certain tax haven and other tax avoidance income of foreign corporations established by U.S. taxpayers. Before this legislation, a U.S. taxpayer could accumulate income outside the United States or engage in tax avoidance transactions through a foreign corporation (often located in a tax haven country) and not pay U.S. tax on that income until the corporation paid a dividend to the U.S. shareholder.

Under the 1962 legislation (Code secs. 951 through 964, often referred to as subpart F), U.S. shareholders of controlled foreign corporations are subject to current taxation on their proportionate share of certain categories of undistributed profits from tax haven type activities and certain other activities of controlled foreign corporations (subpart F income). Foreign taxes paid on income taxed to the shareholders can be credited against any U.S. tax imposed. One category of subpart F income is foreign base company income. Foreign base company income includes foreign personal holding company income. Dividends and other passive income are considered foreign personal holding company income. Generally, a dividend received by a controlled foreign corporation is treated as subpart F income taxable to the U.S. shareholders even if the payor corporation's income is not subpart F income. Foreign base company sales income includes income of a foreign corporation from the purchase and sale of personal property where the property is produced outside the country of incorporation of the corporation and it is sold for use, consumption, or disposition outside of that country. The rule applies if either the seller to or the purchaser from the foreign corporation is related to it. Income received by a controlled foreign corporation is not taxable under subpart F if it is established to the satisfaction of the Secretary of the Treasury that the foreign corporation was not formed or availed of to reduce taxes.

In 1975, the definition of foreign base company sales income was amended to exclude from taxation income of a controlled foreign corporation from the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities.

Issues

The issue presented is whether dividend income received by a U.S. corporation's foreign subsidiary should be excluded from the

general subpart F rule treating dividends as foreign personal holding company income taxable to the U.S. parent, when the distributing corporation's income is from the sale of agricultural products not grown in the United States in commercially marketable quantities and, thus, would not be taxable to the U.S. parent if earned directly by the U.S. parent's foreign subsidiary. The bill would generally exclude dividend income from this general subpart F rule when attributable to the sale of such agricultural products.

Proponents of the bill argue that, contrary to well-established U.S. tax principles, form prevails over substance under the present law subpart F rules for the taxation of income attributable to such agricultural products. If a U.S. parent's first-tier foreign subsidiary sells the agricultural products at issue directly or through a foreign branch, the income from the sales is excluded from taxation by the 1975 amendment to the foreign base company sales income definition. If the U.S. parent's first-tier foreign subsidiary sells the products through a foreign subsidiary of its own instead, the income from the sales is not excluded. The bill would conform the subpart F treatment of income from the sale of the agricultural products at issue when earned through the second-tier foreign subsidiary with the current subpart F treatment of such income when earned directly by the first-tier foreign subsidiary or through a branch of the first-tier foreign subsidiary.

In doing so, however, the bill would introduce a new "look-through" concept to subpart F. The present law rule that most dividends paid to foreign personal holding companies are automatically treated as subpart F income would be altered. If the dividends were found to be attributable to the payor corporation's income from the sale of the agricultural products in question, they would be excluded.

It can be argued, however, that a look-through rule excluding from subpart F income dividend income attributable to sales of the agricultural products at issue is consistent with the overall purpose of the exclusion from foreign base company sales income of the income from the sale of these products. The taxation of foreign base company sales income where two foreign companies are involved as the seller and the ultimate purchaser generally prevents U.S. taxpayers operating abroad from significantly reducing their average foreign tax rates by establishing tax haven sales subsidiaries. The purpose of preventing this reduction in average foreign tax rates is to prevent foreign investment from gaining a tax advantage over U.S. investment. In other words, the taxation of foreign base company sales income is undertaken to promote capital-export neutrality. Since U.S. investment is not feasible in the case of the agricultural products at issue (because such products cannot be grown economically in the United States), capital-export neutrality between U.S. and foreign investment is arguably not an issue with respect to these agricultural products.

Finally, it can be argued that if relief from subpart F taxation is appropriate in the type of case addressed by the bill, it may better be provided by expanding the present subpart F exception for foreign corporations not formed or availed of to reduce foreign taxes to take into account this type of case.

Explanation of the Bill

For purposes of subpart F, the bill would exclude from foreign personal holding company income certain dividends received by a controlled foreign corporation from another foreign corporation if certain conditions are met. These conditions are:

(1) The dividends are out of the earnings and profits of the payor corporation for a taxable year in which at least 70 percent of its gross income (other than gross income taken into account in determining subpart F income) is from the purchase or sale of agricultural commodities which were not grown in the United States in commercially marketable quantities;

(2) The two corporations are members of the same affiliated group;

(3) A U.S. shareholder owns (within the meaning of Code section 958(a)) more than 50 percent of the stock of both corporations;

(4) The dividend-receiving corporation and either the payor corporation or another foreign corporation controlled by the payor corporation on the date of acquisition[1] was in existence for at least the five years immediately before the acquisition of its stock by the U.S. shareholder; and

(5) The payor corporation or the other foreign corporation controlled by it was engaged in the active conduct of a trade or business during the five-year period just described.

Thus, provided the above conditions are met, when agricultural commodities which are not grown in the United States in commercially marketable quantities are purchased or sold by a foreign corporation and that corporation pays a dividend to a related controlled foreign corporation, the dividend would not be considered foreign personal holding company income for purposes of subpart F and would not be subject to taxation to the U.S. shareholders.

It is understood that Consolidated Foods Corporation would be the primary beneficiary of this amendment although other similarly situated taxpayers would also be affected.

Effective Date

The provisions of the bill would apply to taxable years of foreign corporations which begin after 1983 and to taxable years of U.S. shareholders within which or with which the taxable years of the foreign corporations end.

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[1] The date of acquisition referred to here in the bill is apparently the date of acquisition of the payor corporation's stock by the U.S. shareholder.

Congress of the United States

JOINT COMMITTEE ON TAXATION

Washington, D.C. 20515

ERRATA SHEET FOR JCS-51-83
October 27, 1983

(1) On page 13, the last sentence of the second paragraph under the heading **Depreciation** should read as follows:

"The anti-churning rule would apply, for example, if an investor-lessor entered into a sale-leaseback of property owned in 1980 by the seller-lessee."

(2) On page 16, the paragraph under the heading **Business use of principal residence rented under qualified sale-leaseback transaction**, should read as follows:

"Under the bill, rent paid by a seller-lessee under a lease constituting part of a qualified sale-leaseback transaction would not be subject to the business expense limitations imposed on persons making a business use of a residence."

J862-82
S362-52